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No. 224

In the Supreme Court of the United States

OCTOBER TERM, 1961

THE HANOVER BANK, EXECUTOR, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT

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OPINIONS BELOW

Two cases are jointly presented for review. The findings of fact and opinion of the Tax Court in *Gourielli* (R. 76–81) are reported at 33 T.C. 357. The findings of fact and opinion of the Tax Court in *Goldfarb* (R. 130–135) are reported at 33 T.C. 568. The single opinion of the court of appeals (R. 139–151) is reported at 289 F. 2d 69.

JURISDICTION

The judgments of the court of appeals in both cases were entered on April 13, 1961 (R. 151–152). The

joint petition for a writ of certiorari was filed on July 11, 1961, and was granted on October 9, 1961 (R. 153). The jurisdiction of this Court rests upon 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the limited rights afforded a borrower under sinking fund and related security provisions of an indenture to redeem a portion of the bonds on 30 days' notice at a special redemption price establish an "earlier call date" within the meaning of Section 125 of the Internal Revenue Code of 1939, thereby enabling taxpayers who purchase such bonds to write off the difference between their basis and the special redemption price as a deduction from ordinary income in the year of purchase.

STATUTE AND REGULATIONS INVOLVED

The pertinent statute and Treasury Regulations are set forth in the Appendix, *infra*, pp. 47–51.

STATEMENT

The facts of the two cases (*Gourielli* and *Goldfarb*) are substantially similar.

Gourielli

In October of 1953, Gourielli and his wife purchased, for cash, a total of $540,000 face amount of Appalachian Electric Power Company first mortgage, 3¾ percent, 1981 series, bonds for $634,500 ($117.50 per $100 face amount), plus commissions, and approximately one month later sold the bonds for $623,-

700 ($115.50 per $100 face amount), less commissions.[1] The bonds were part of a $17,000,000 issue out of a total of $157,000,000 of first mortgage bonds then outstanding under the same mortgage and deed of trust.[2] The indenture afforded Appalachian an unlimited option to redeem all or any portion of the bonds on 30 days' notice by paying a stated "regular redemption premium," the amount of which declined as maturity approached. The "regular" redemption price applicable to the period involved here was $105.375 per $100 face amount (R. 74).

The indenture also gave Appalachian a limited right to redeem a part of the bonds, to be drawn by lot, at a lower "special" redemption price ($102.375 for the relevant period). That right was limited to the amount of money on deposit with the trustee at any time in three narrowly defined funds: (1) the "sinking fund", to which Appalachian was entitled (and, unless it certified property additions in an equivalent amount,

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[1] The bonds were issued in denominations of $1,000 but, for convenience, the selling and call prices are stated in terms of hundreds. Three purchases and sales are involved, as shown in the following table (R. 74, 77):

Principal Amount	Date Purchased	Date Sold	Cost	Sales Price
$130,000	10/8/53	11/12/53	$132,700	$130,130
200,000	10/14/53	11/13/53	202,800	200,800
124,000	10/23/53	11/27/53	126,200	127,050
			824,800	823,700
Commissions paid			1,200	1,200
			823,800	822,200

[2] An additional $74,000,000 face amount of bonds was issued by Appalachian under the same mortgage and deed of trust between the time of these transactions and the proceedings in the Tax Court (R. 75, 79).

required) to deposit during each annual period an amount equal to one percent of the bond issue; (2) the released property and insurance funds, to which deposits were required or permitted only upon a loss by casualty or a release by the trustee (*e.g.*, to permit a sale) of mortgaged properties; and (3) the maintenance fund, to which deposits were required or permitted only if Appalachian failed to expend a stated percentage of its revenues on maintenance or improvements. Thirty days' notice was required for a redemption under those provisions (R. 77–78, 142–143).

To the date of the hearing in the Tax Court in May 1959 (R. 4), Appalachian had never called or redeemed any of its bonds at either the regular or the special redemption prices (R. 75, 77–79, 141–143). Up until the time the Gouriellis disposed of their holdings, Appalachian had never deposited any funds to either the sinking fund or the maintenance fund and had received no insurance proceeds in cash. The sum of $42,626.30 was available in the released property fund for redemption of the $17,000,000 issue of which the Gouriellis' $540,000 face amount was a part (R. 26, 75, 77–79; see 141–143). The Tax Court found that there was "no likelihood" of redemption at the special redemption price (R. 79), as did the court of appeals, which stated (R. 143):

> * * * the chance that the company would engage in so ill-advised an endeavor [as a special redemption] during petitioners' brief ownership was thus exceedingly remote; and the hazard that any significant number of petitioners' bonds would be called during that period was infinitesimal.

In their 1953 income tax return the Gouriellis elected to avail themselves of Section 125 of the Internal Revenue Code of 1939, which permits an elective deduction for amortizable bond premium computed with reference to the amount payable at "maturity" or "on earlier call date" (R. 74). In computing the amount of the deduction, taxpayers assumed that they were entitled to deduct the entire bond premium in 1953 because the bonds were callable upon 30 days' notice and determined the amount of the bond premium with reference to the "special" redemption price of $102.375. They accordingly claimed a deduction for amortizable bond premium in the amount of $83,056.07 (the excess of their total $635,850 cost over the $552,825 they would have received if all the bonds had been called in that year at the special redemption price) (R. 74, 78, 141). In auditing the Gouriellis' 1953 tax return, the Commissioner did not question their use of the 30-day amortization period. However, he recomputed the amount of the bond premium using the general, instead of the special, redemption price ($105.375) and accordingly reduced the amount of the deduction to $64,831.07 and determined a tax deficiency of $14,200.92.* (R. 75, 78, 141-142.) The Tax Court sustained the Commissioner's deficiency determina-

*Under Section 113(b)(1)(H) the basis for the bonds is reduced by the amount of the amortizable bond premium deduction. Therefore, even though the Gouriellis sold their bonds for two points less than their purchase price, they had short-term capital gain on the sale (R. 141). The gain was offset against short-term capital losses which they had incurred prior to purchasing the bonds (R. 10-11, 80).

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tion (R. 76-82) and the court of appeals unanimously affirmed (R. 139-151).

Goldfarb

In November of 1953, petitioner Goldfarb purchased a total of $600,000 face amount of Arkansas Power & Light Company, 4¼ percent, 30-year, Eighth Series, first mortgage bonds for $553,575 (including brokerage commissions of $1,260), and thus at an average price of approximately $110.50 per $100 face amount (R. 122, 131, 142). He sold the bonds on June 16, 1954, for $537,000 (less commissions and selling expenses of $675), and thus at an average price of approximately $105.40 per $100 face amount (R. 125, 131, 142).*

Under the covering indenture and deed of trust, Arkansas possessed an unconditional right to call all the bonds at any time upon 30 days' notice prior to their fixed maturity date at a general redemption price of $105.26 payable from general funds. The indenture also afforded the company a limited right to redeem a fraction of the bonds upon 30 days' notice at a special redemption price of $101.26 payable from cash deposited beforehand in four special funds (R. 123, 132, 142-144):

(1) the sinking and improvement fund;

(2) the maintenance and replacement fund;

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*The Goldfarbs reported long-term capital gain on their sale of the bonds in 1954 (R. 131-132), which is not before the Court. Like the Gourellis (see fn. 3, *supra*, p. 5), the Goldfarbs had gain on the sale because their basis for the bonds was reduced by the amount of their amortizable bond premium deduction.

(3) the released property fund; and
(4) the eminent domain fund.

The company's right to place cash in these funds was severely limited. The indenture barred it from transferring cash to any fund other than the sinking fund except where strictly defined contingencies occurred such as the loss of secured property through eminent domain. Absent the contingency—and there was no right to anticipate (R. 145)—no monies could be made available to redeem bonds at the special redemption price. With respect to the sinking fund, Arkansas had the unlimited right each year to transfer cash up to one percent of the $18,000,000 of Eighth Series bonds outstanding (R. 142–144). In no case, however, was the company required to make deposits in cash. It could, and without exception did (R. 133), meet its commitments to the four funds by investments in new construction or improvements to the secured property (*Ibid.*).

Thus, as a matter of right, Arkansas possessed an option each year to redeem at the special redemption price one percent of the bond issue of which the Goldfarbs held a small part. In fact, as found by the court of appeals, there was no cash in any of the funds during 1953 and "no evidence that any receipts were in prospect" (R. 145). No cash was ever deposited to any of the funds during the life of the bonds from their issue, through their purchase and sale by the Goldfarbs in 1953 (R. 126–127, 132–133, 144–145), to their redemption at the general redemption price on April 18, 1955 (R. 125, 132, 145). On these facts the Tax Court found that "There was no

likelihood that Arkansas would redeem * * * at the special redemption price in 1953" (R. 134) and the court of appeals reached the same conclusion (R. 148).

In their 1953 income tax return, the Goldfarbs, like the Gourielis, claimed 20-day amortization of the premium paid upon purchase of the bonds and computed it with reference to the "special" redemption price of $101.36. They accordingly claimed an amortizable bond premium deduction in the amount of $67,175—the excess of the $553,975 cost of the bonds over the $506,800 they would have received if all of the bonds had been redeemed in that year at the special redemption price (R. 124, 134, 142). The Commissioner reduced the deduction to $27,175, computing it with reference to the general, instead of the special, redemption price (R. 124, 134, 142). The result was a tax deficiency of $14,708.16 (R. 130, 135), which the Tax Court sustained (R. 130-135) and the court of appeals affirmed (R. 139-151).

SUMMARY OF ARGUMENT

Section 125 of the 1939 Code authorizes the amortization of bond premium—*i.e.*, its deduction from ordinary income—over the period to "maturity" or, if the bond is callable, to an "earlier call date." If amortization is based on a right of call, the deduction is limited to the excess of the cost over the redemption price at which that right is exercisable.

In this case, petitioners purchased, at substantial premiums, bonds subject to an indenture that permitted the issuer: (1) to redeem all or any part of the

bond issue upon 30 days' notice at a "general" redemption price of $105; (2) to redeem 1% of the bond issue upon 30 days' notice at a "special" redemption price of $102, the bonds to be redeemed to be determined by lot; and (3) to redeem an indeterminate number of bonds, at the special $102 price, if and when stated contingencies largely beyond its control should happen to occur (*e.g.*, the destruction or condemnation of the mortgaged property). Since the redemption rights were exercisable at different prices, it is necessary to consider each of those rights separately to determine which, if any, constituted a right to "call" petitioners' bonds and thereby created a basis for amortization under the statute.

1. The first, and most important, right of redemption reserved by the issuers was the unlimited right to redeem all or any part of the bonds at any time upon 30 days' notice. That right could have been exercised to redeem all of the bonds as early as the 31st day after the purchase. Accordingly, we concede that, to the extent of that right of redemption, the 31st day after purchase was an "earlier call date" to which all of the bonds were subject. Petitioners were, therefore, entitled to amortize over the first 30 days of their holding the difference between the cost of the bonds and the price payable upon an exercise of that right ($305).

2. The second redemption right reserved by the issuer was the right, upon 30 days' notice, to redeem out of a "sinking fund" up to 1% of the bond issue at a price of $102, the bonds to be redeemed to be chosen by lot. Unlike a general right to redeem all

the bonds, such a limited right to redeem an unidentified 1% of the bonds does not, we submit, establish an "earlier call date", either for the entire issue or for any particular bonds in the issue. It accordingly provides no basis for immediate amortization of any part of the premium.

The statute speaks in terms of the amortization deduction to be allowed on individual bonds and thus requires that the right to amortization be determined separately for each bond. To justify early amortization, therefore, it is necessary to establish a "call date" for the particular bond on which amortization is claimed. When the issuer's rights are limited to redeeming only a small number of bonds, to be chosen by lot, however, it is evident that no particular bond in the issue can be said to be subject to "call"—*i.e.*, a right in the issuer to redeem that bond at its option. The individual bonds, then, have no ascertainable "call date" to which amortization might be taken. Under the very terms of the statute, therefore, no "call date" amortization can be based upon such a limited redemption right.

That interpretation of "call date" is confirmed by the further provision of the statute requiring that a "reasonable" method of amortization be used. It is plainly not reasonable, we submit, to deduct the premium immediately upon an entire issue of bonds because the issuer has a right to redeem a bare 1% of them. The only reasonable amortization in such a case is that permitted by the Commissioner's published ruling—namely, the amortization of the premium when

the redemption right is exercised and the bonds to be redeemed are identified.

3. The final redemption right retained by the issuer was the right if, for example, mortgaged property should be condemned, to use the proceeds of condemnation to redeem bonds, drawn by lot, at the special $102 price. Like the "sinking fund" redemption rights discussed above, that right was limited to redeeming only a fraction of the bonds and thus, for the reasons here discussed, was not a right of "call" as to any particular bond. Additionally, however, and unlike the sinking fund rights, that right was contingent upon stated events occurring in the future and was thus not even an existing right in the year of purchase. Since that right would become exercisable, if at all, only at some indeterminate time in the future, there was plainly no ascertainable "call date" to which amortization based on that right could be taken.

Since the "special" redemption provisions do not establish a date upon which any identified bond may be redeemed, and thus do not establish an "earlier call date" for any of petitioners' bonds, those provisions afford no basis for amortization to "call dates." The only redemption right that does fix an ascertainable "call date" is the general right of the issuer to redeem all or any part of the bonds upon 30 days' notice. It is, therefore, exclusively on the basis of that redemption right that the petitioners are entitled to claim immediate amortization. The entitlement to such amortization being based solely upon that redemption right, it necessarily follows that the amorti-

nation can be taken only to the redemption price that would be payable upon an exercise of that right—namely, the "general" $105 price.

ARGUMENT

INTRODUCTION

Sound accounting requires the amortization of the premium paid for interest-bearing bonds in order clearly to reflect income. If a $100 face value 20-year bond bearing interest at 5% sells on the market for $110, it is presumably because the 5% interest it bears is above the current market rate for similar securities. Over the 20-year life of the bond, the holder will receive each year interest payments in excess of the current rate, and it is for the right to receive those "excess" payments that the $10 premium is paid. The nominal interest payments, accordingly, are not the true interest yield on the bond but represent in part a return of the premium paid for the right to receive them. Clearly to reflect the taxpayer's interest income, therefore, it is necessary to offset against the nominal interest payments a pro rata part of the premium paid for the right to receive them—*i.e.*, to "amortize" the premium over the 20-year life of the bond by deducting $0.50 each year. If the nominal interest payments were taxed in full as ordinary income, without an offsetting deduction, the taxpayer's income would be exaggerated during the first 19 years of holding and he would then realize an artificial capital "loss" upon the redemption of the bond at its face value.

The reason for amortizing the premium over the full 20-year period is that the taxpayer is assured of receiving the above-market interest payments for which the premium was paid for the full period to maturity. Suppose, however, the bonds were callable, at the issuer's option, at the end of 10 years at a redemption price of $104. In that event, the holder would be assured of receiving the favorable interest only for 10 years. It therefore seemed reasonable to treat the $6 premium in excess of the redemption price as being paid for the right to receive the interest for the 10-year period and allow it to be amortized over that shorter period of assured holding.

It was to give effect to those principles of accounting that Congress in 1942 adopted Section 125 of the 1939 Code, which for the first time provided for the amortization of bond premiums for tax purposes. In brief, that section permits a taxpayer to amortize the premium paid for a bond over the period to "maturity" or, at his election, to an "earlier call date." The amount of the premium amortizable over the chosen period is, of course, limited to the excess of the purchase price over the amount payable upon redemption on the date to which the premium is being amortized.

The question in this case is what rights of redemption with respect to the particular bond for which amortization is claimed constitute a right to "call" that bond so as to establish a "call date" to which amortization may be taken. The bond indentures involved gave the issuers three quite different kinds of

redemption rights, and the question is which of those rights affords a basis upon which call-date amortization may be claimed. Briefly, the three kinds of rights retained by the issuers were as follows:

(1) The issuer was entitled at any time, upon giving 30 days' notice, to redeem all or any part of the issue at a so-called "general" price of approximately $105.

(2) The issuer was entitled, upon giving 30 days' notice, to redeem up to 1% of the issue, to be chosen by lot, at a "special" price of approximately $102.

(3) The issuer had a contingent right, if and when certain contingencies largely beyond its control should happen to occur (*e.g.*, if mortgaged property should be taken by eminent domain), to redeem an indeterminate part of the issue at the "special" price of $102. Once that right was brought into being, by the happening of the event, it was exercisable upon the giving of 30 days' notice.

The determination of which of those three "redemption liabilities" creates a right to amortization is important in this case because the redemption rights were exercisable at different prices. If, for example, the right of the issuer to call 1% of the bonds chosen by lot is by itself deemed a sufficient liability to redemption to authorize amortization of all the bonds to the date on which that right is exercisable, it would follow automatically that the amount of the amortizable premium would be the excess of the purchase price over the amount payable upon exercise of that right—*i.e.*, the "special" $102 price.

If, on the other hand, the only liability to redemption that qualifies under the statute as a basis for amortization is the unlimited general right of call, it would follow that amortization should be allowed only down to the price at which that right is exercisable—*i.e.*, the "general" $105 price.

Thus, while the ultimate question in this case is one of the *amount* of amortization allowable, that is only because of the happenstance that the single indenture contained a variety of redemption rights. The controlling question is which of those redemption rights creates a *right* to amortization, a question that would be precisely the same if the case involved several issues of bonds each of which was subject to only one of the redemption rights. The specific question of statutory interpretation, therefore, is what is meant by the phrase "earlier call date"—*i.e.*, what kinds of redemption rights create an "earlier call date" within the meaning of the statute and thereby justify amortization to that date. To put it another way, to what rights of redemption must a particular bond be liable in order for that bond to be deemed "callable" in the statutory sense: an unrestricted option in the issuer to redeem it; a 1% chance of being among the bonds the issuer is entitled to draw by lot for redemption; or a contingent liability to being redeemed if and when stated events occur?

It is our position that a particular bond is subject to an "earlier call date" only if there is an ascertainable date on which the issuer will become entitled to redeem that bond at its option. In this case, as we will show, it is only the general right of the issuers

to redeem all or any part of the issue at any time upon 30 days' notice that meets that test. A right to redeem a small number of unidentified bonds to be drawn by lot does not establish an ascertainable "call date" for any particular bond; and a right to redeem upon the happening of contingent future events does not establish any ascertainable "date" at all. And if the general right of call is the only basis upon which call-date amortization is allowable, it follows automatically that the amount of amortization allowable over that period must be measured by the excess of the purchase price over the amount payable upon an exercise of *that* redemption right—*i.e.*, the "general" $105 price.

Contrary to petitioner's assumption (Br. 26-29), our position is not dependent upon the particular market conditions or the actual probabilities that a right of redemption will be exercised. Rather, it is based solely upon the legal "rights" reserved by the issuer in the indenture, which either do or do not create a liability to "call" within the meaning of the statute. While an awareness of the practical significance of the various kinds of redemption rights may be relevant in assessing the Congressional purpose and thus in interpreting the statute, we agree with petitioners that the question must be resolved by a general rule and should not be dependent upon a finding in each case of the actual "likelihood" that any particular redemption right will be exercised.

Although we concede that the general right of redemption involved in these cases does establish an "earlier call date" to which amortization may be

taken, it is appropriate to examine the premises of that basis for amortization before turning to the disputed questions of the effect of the other two kinds of redemption rights upon the amortization allowable. That is important not only to emphasize the basic difference in kind between the several redemption rights but also to show the abuses to which even that basis of amortization has led by itself a more than sufficient reason for not extending the loophole to "special" redemption provisions.

I

DESPITE THE ABUSES TO WHICH IT HAS LED, AMORTIZATION OVER THE NOTICE PERIOD OF THE PREMIUM PAID FOR BONDS CALLABLE UPON NOTICE CAN NO LONGER BE CHALLENGED

Petitioners commence their argument by conceding that rapid amortization of bond premiums constitutes a tax loophole of major dimensions but contend that the "hole in the dike" calls "for the application of the Congressional thumb, not the court's" (Br. 13–18). Moreover, as they point out, when Congress did finally close the hole—partially in 1954 and completely in 1958—it did so only prospectively, acknowledging and impliedly accepting the interpretation that had been given to Section 125 of the 1939 Code. From that they argue the impropriety of the government's attempt to have the courts close the door retroactively for prior years.

We acknowledge the force of petitioners' argument if confined to its proper scope. The difficulty is that the argument goes only to the issue which the govern-

ment, for those very reasons, has conceded—namely, that a purchaser of a bond subject to a general right of call upon 30 days' notice is entitled to amortize the difference between his cost and the "exercise" price over the first 30 days of his holding. As we will show, that basis of amortization has itself produced widespread abuses and provides a full explanation for the subsequent Congressional action. The question in this case is not whether that loophole can be closed retroactively but whether it should be extended still further to permit additional rapid amortization on the basis of limited or "special" redemption rights.

1. The major right of redemption retained by the issuers in these cases was, as we have noted, an unlimited and unrestricted right to redeem all or any part of the bonds at any time upon 30 days' notice. While a write-off of the entire premium over such a short period is hardly consistent with the underlying purpose of the statute, it seems to have been generally assumed that there was nothing in the statute to prevent taxpayers from writing off the premium paid for such bonds over the first 30 days of their holding, treating the end of the required notice period as an "earlier call date" within the meaning of the statute. Thus, for example, the use of a 30-day amortization period, on that basis, was not even questioned in *Commissioner* v. *Korell*, 339 U.S. 519, and there seem to have been no attempts administratively to oppose that basis for amortization. Finally, in 1956 the Commissioner issued a formal ruling approving a 30-day write-off of the premium on bonds

callable on 30 days' notice. Rev. Rul. 56-398, 1956-2 Cum. Bull. 964.

At first sight, premium amortization on 30-day callable bonds would not seem of great significance, since a bond immediately callable would presumably not sell for much more than the call price. In point of fact, however, several issues of such bonds began to change hands at very high premiums precisely because they *were* callable on short notice (a feature that permitted immediate write-off of the premium against ordinary income). The most prosaic tax advantage of such a bond is the conversion of ordinary income into long-term capital gain. A bond callable on 30 days' notice at $105 is purchased for $120; the $15 "premium" is immediately deducted from ordinary income; after six months the bond is sold for $120, producing, with no change in market values, a long-term capital gain of $15. For a taxpayer in the 80% bracket, the $15 deduction reduces his tax bill by $12 while the $15 long-term gain increases it by only $3.75, producing an after-tax "profit" of $8.25. If the taxpayer has accumulated unused capital losses to offset against the gain, moreover, he can achieve substantially the same benefit by holding the bond only 31 days and taking a short-term capital gain. Those are substantially the transactions involved in these two cases; the Goldfarbs sold at the end of six months for a long-term gain and the Gouriellis took a short-term gain at the end of 31 days to utilize accumulated capital losses.

More sophisticated transactions are revealed by other cases. In buying the bond for $120, the taxpayer

pays only $15 in cash and borrows the balance, pledging the bond as security. After 31 days, he makes a gift of his $15 equity (assuming a constant market price) to a charity. The charity then sells the bond and discharges the indebtedness. The taxpayer is out of pocket $15, but has obtained deductions totalling $30 (a bond-premium amortization deduction of $15 and a charitable contribution deduction of $15), which, in the 50% bracket, will reduce his tax bills by $24. That was the transaction involved, for example, in *Mogutect Products, Inc.* v. *Commissioner*, 287 F. 2d 429 (C.A. 7); *Friedman* v. *Commissioner*, 294 F. 2d 876 (C.A. 1); and *Evans* v. *Dudley*, 295 F. 2d 713 (C.A. 3). In another variant, a corporation buys the bonds, holds them for 31 days, and then declares the bonds, subject to an indebtedness equal to the call price, as a dividend in kind to its stockholders. The effective dividend to the stockholders is the amount of the premium, and the corporation, in deducting the premium, has in effect found a way to deduct dividends.* It was that transaction that was involved in *Fabreeka Products Co.* v. *Commissioner*, 294 F. 2d 876 (C.A. 1). When such transactions are carried out on a large scale, as they typically have been (*e.g.*, the transaction in *Evans* involved the purchase and

*Nor is that the end of the tax windfalls. The stockholders will account for the bonds as a dividend and thus receive a full fair market value basis ($120), on which they too will presumably be able to take a 30-day write-off of the excess over the call price. Thus, not only is the corporation able to deduct the dividend, but the dividend income to the stockholders is immediately offset by a second amortization deduction and is ultimately taxed (if at all) only as a capital gain.

gift to charity of $2,000,000 face amount of bonds by a taxpayer in the 91% bracket), the tax savings become remarkable, and it is little wonder that the demand for such bonds has caused them to sell at such extravagant premiums. Indeed, the higher the premium the greater is the tax advantage and the more attractive is the bond as a tax investment (provided the demand can be counted on to sustain the price for 31 days).

2. Aided by hindsight, it now seems to us that the unchallenged acceptance of an immediate write-off of the premium on bonds callable on notice—the source of the above abuses—was perhaps unnecessary. The basic principle of amortization of premium to call dates is to allow the recovery of the premium over the period for which the holder is assured of continuing to hold the bond and thus receive the interest for which he is presumed to have paid the premium. If so, it may be that amortization on 30-day callable bonds could successfully have been challenged on the ground that, until notice of call is actually given, the period of assured holding never begins to expire: as each day passes without receipt of notice, the bondholder is assured of at least 30 days more holding. Except for the steady approach of the maturity date (which would justify amortization only to maturity), he has as much at the end of any period of time during which no notice of call was received as he had at the beginning. Until notice of call is actually given, therefore, nothing is being "used up" over time and there is no justification for

amortization of the premium other than to the maturity date.

Whatever the merits of that argument, however, we consider that it is now too late to challenge the amortization of the premium on bonds subject to an unlimited right of redemption on 30 days' notice. Not only has the consistent administrative practice, culminating in a published ruling, been to allow such amortization, but Congress, in narrowing such deductions in the 1954 Code and prohibiting them entirely after 1957, expressly acknowledged that the prior law permitted that treatment.[4] In the light of that history, not even the great abuses to which the rule has led are sufficient, in our view, to justify asking the courts now to adopt, for the first time, a contrary interpretation. Accordingly, we did not challenge in the lower courts and do not challenge here petitioners' right to amortization of the premium on the basis of the general right of the issuer to redeem the bonds at any time upon 30 days' notice. On that basis of amortization, they are admittedly entitled to a 30-day amortization deduction measured by the difference between the purchase price of the bonds and the amount payable upon the exercise of that general redemption right—namely, the "general" call price of approximately $265.

[4] The legislative history is considered in detail at pp. 30-32, *infra*.

That concession, we suggest, considerably blunts petitioners' charge that the government is here seeking from the courts what Congress refused to give: a retrospective plugging of the "hole in the dike" that has permitted such abuses. Rather, we concede our inability to prevent the basic abuse—a concession that, for example, gave the Gourielli's almost $65,000 of their claimed $88,000 deduction—and seek here only to prevent a further expansion of the loophole. And, as we will show, nothing in the statute or its history requires the Court to permit such an expansion.

II

THE RIGHT OF AN ISSUER, UPON A GIVEN DATE, TO REDEEM A SMALL NUMBER OF UNIDENTIFIED BONDS, TO BE DRAWN BY LOT, DOES NOT ESTABLISH AN "EARLIER CALL DATE" FOR THE ENTIRE ISSUE SO AS TO PERMIT THE PREMIUM ON ALL THE BONDS IN THE ISSUE TO BE AMORTIZED TO THAT DATE

In addition to the unlimited right to redeem all or any part of the bonds at any time upon notice, the issuers had the right under these indentures to redeem bonds, at a lower "special" redemption price (approximately $102), out of certain funds established under the indenture. Those funds, of several kinds, consist basically of amounts the issuer is required to set aside, subject to various options, in order to prevent impairment of the security underlying the bond issue. We will consider here only the so-called "sinking fund." The other funds present quite different problems and will be considered separately in Point III, *infra*.

The sinking fund provisions of both the Arkansas bonds and the Appalachian bonds were substantially similar. In each case, the issuer was entitled each year to transfer to the sinking fund an amount no greater than 1% of the face amount of the issue. Since in neither case had any deposits been made to the fund in prior years, that limitation on contributions to the sinking fund effectively limited the issuers' rights to redeem bonds out of the sinking fund, in the year of purchase, to a right, at its option, to redeem up to 1% of the bond issue. If it chose to exercise that right, which could be exercised at any time upon 30 days' notice, the bonds to be redeemed were to be chosen by lot.

As of the date of purchase, therefore, the net effect of the sinking fund provisions was to give the issuer an unconditional right, upon 30 days' notice, to redeem at a stated price up to 1% of the bond issue, the bonds to be redeemed to be determined by lot. The question is whether that right—viewed, as it must be, independently of the other redemption rights—established an "earlier call date" with respect to all or any of the bonds held by petitioners so as to entitle them to amortize their premium (computed on that basis) to the date upon which 1% of the outstanding bonds might be called (*i.e.*, 30 days from purchase). We contend that such a right, since the bonds against which it is exercisable are unidentifiable, does not fix an "earlier call date" for any of the bonds—until, of course, the right is exercised and the bonds are identified by being chosen by lot—and therefore does not provide a basis for immediate amortization.

A. THE STATUTE REQUIRES, FOR AMORTIZATION TO A CALL DATE, THAT THE PARTICULAR BOND FOR WHICH AMORTIZATION IS CLAIMED BE SUBJECT TO AN EXISTING RIGHT IN THE ISSUER TO CALL THAT BOND FOR REDEMPTION AT AN ASCERTAINABLE RATE

1. Section 125 provides in part (emphasis added):

> (a) *General Rule.*—In the case of *any bond,* as defined in subsection (d), the following rules shall apply to the amortizable bond premium (determined under subsection (b)) on *the bond* * * *:
>
> (1) *Interest wholly or partially taxable.*—In the case of *a bond* (other than a bond the interest on which is excludible from gross income), the amount of the amortizable bond premium * * * shall be allowed as a deduction.
>
> * * * * *
>
> (b) *Amortizable bond premium.*—
>
> (1) *Amount of bond premium.*—For the purposes of paragraph (2), the amount of bond premium, in the case of the holder of *any bond,* shall be determined with reference to the amount of the basis * * * of *such bond,* and with reference to the amount payable on maturity or on earlier call date, with adjustments proper to reflect unamortized bond premium with respect to *the bond,* for the period prior to the date as of which subsection (a) becomes applicable with respect to the taxpayer with respect to *such bond.* * * *
>
> (2) *Amount amortizable.*—The amortizable bond premium of the taxable year shall be the amount of the bond premium attributable to such year. [Emphasis added.]

From the italicised references to "a bond", "any bond," "the bond," and "such bond," read in context, it is evident that the structure of the section is in terms of prescribing the amortization allowable on individual bonds, not on issues or groups of bonds. Thus the phrase "earlier call date"—the sole statutory basis for call-date amortization—can only mean the "earlier call date" of the particular bond for which amortization is claimed. To justify amortization over a period short of maturity, therefore, the taxpayer must show that each bond is individually subject to "call" at some identifiable date—*i.e.*, that the particular bond has an "earlier call date." Giving to "call" as used in the statute its ordinary meaning of an option in the issuer to redeem the bond, a right to "call" a bond must mean that the issuer has a right, exercisable at its choice, to redeem that particular bond. And plainly the sinking fund provisions here give the issuer no such right: as to any particular bond, the issuers' rights are limited to a 1-out-of-100 chance of picking that bond out of a hat, rights that are far closer to a Sweepstakes ticket than to an "option."

In short, under the statute it is not enough that the issuer has a right to call *some* bonds out of an issue, to be drawn by lot. It must have the right to call the particular bond for which amortization is claimed, for otherwise *that* bond has no "earlier call date." On the face of the statute, therefore, the requirement of an "earlier call date" requires, we submit, that there be an existing right, at some ascer-

tainable time, to call for redemption the particular bond for which amortization on that basis is claimed. The sinking fund provision does not confer such a right and therefore does not itself give rise to a right to rapid amortization.

2. The above interpretation of "earlier call date" is required also by the further provision of the statute (Section 125(b)(3)) requiring that the determination of the amount of the bond premium and of the years to which it is to be attributed be made in accordance with a "reasonable" method of amortizing bond premium. When the issuer has a right to call the entire issue at any time upon short notice, it is perhaps reasonable—if unduly conservative—to write off the entire premium immediately and carry the bonds only at the price that would be received should the right be exercised. Whatever the abuses to which such a write-off is subject, there is at least the theoretical justification that all of the bonds are held at the "sufferance" of the issuer. Not even that conceptual justification exists, however, when the right of call is limited to calling 1% of the outstanding bonds, to be chosen by lot. In such a case, even if the worst should happen and the right be exercised, there is still only one chance in a hundred that any particular bond will be among those chosen for redemption. Or, stated in terms of a large holding, the statistical probabilities are that an exercise of the redemption right would result in the redemption of but 1% of the taxpayer's holdings. Yet petitioners would contend that, to guard against the issuer's exercise of its right to call 1% of the bonds, it is a "reasonable" method of accounting

to treat the entire issue as being in "jeopardy" of a call and write off immediately the premium on all the bonds. A more than sufficient answer to the claim was given by Judge Friendly for a unanimous court of appeals (R. 148):

> Taxpayers have cited no authority that it is sound accounting practice to provide, within 30 days after acquiring a bond, a reserve large enough to meet not only every risk of call that could eventuate during the amortization period but also one that could not. Cf. *Massey Motors, Inc.* v. *United States*, 364 U.S. 92, 104–106 (1960). * * *

Nor can petitioners' method be justified on the ground that, since it is not known which bonds would be called if the sinking-fund rights were exercised, there is no alternative, short of denying any deduction, to allowing deduction of the premium on all the bonds. Even if that were the choice, it seems a large price to pay to give a taxpayer 100 deductions to make sure that he does not miss one (*i.e.*, to allow him deductions on 100% of the bonds because he cannot tell which 1% he is entitled to deduct). But that is not the choice, for the Commissioner's published ruling disallowing the immediate amortization to "special" call prices goes on to provide that amortization down to that price may be taken if and when a notice of call is actually received. Rev. Rul. 56–398, 1956–2 Cum. Bull. 984, 987. That makes full provision for the recovery of the taxpayer's "capital" out of income and gives to him all that he is entitled to receive equitably or otherwise.

The above discussion, it should be noted, accepts at full value petitioner's implicit premise that a right of call should be treated as the equivalent, for purposes of determining the proper amortization, of a certainty of call. It relies solely on the limited nature of the *rights* of redemption and not at all upon the unlikelihood of those rights being in fact exercised. As we have said, we agree with petitioner that the issue should not turn upon a finding in individual cases of the probability of the issuer exercising its rights. Nevertheless, in resolving any doubts about the proper interpretation of the statute, it is proper, we believe, to take into account the practical significance of such limited rights of call, not in the particular case or particular bond issue as such, but in the financial community at large. To that extent, the testimony of the expert witnesses in this case, adopted by the findings of the Tax Court and confirmed by the history of the widely-traded and important issues directly involved here, that such "special" and limited rights of call are only very rarely exercised (R. 79, 103–104, 134–135) and have no substantial effect upon market prices (R. 97, 113) does become relevant. When there is added to the limited nature of the *rights* an awareness that there is no substantial likelihood in most cases that the limited rights would ever be *exercised*, the lack of substance to petitioners' argument becomes apparent. To interpret the statute to permit rapid amortization with respect to an entire issue of bonds whenever the issuer has a right to redeem any part of the issue, however small, is to give tax windfalls

to hundreds of taxpayers—including not simply the bondholders at any one time but all the successive purchasers of bonds that tend to change hands every 31 days—in order to protect against the practically nonexistent risk that a small fraction of the bonds will in fact be redeemed. Nothing in the statute requires such an interpretation.

B. THE PURPOSE AND LEGISLATIVE HISTORY OF THE AMORTIZATION PROVISIONS REQUIRE THAT THE PROVISION PERMITTING AMORTIZATION TO CALL DATES BE STRICTLY CONSTRUED

If there remains any ambiguity over the meaning of "earlier call date" as it is used in the statute—*i.e.*, whether it requires a right to call the particular bond or whether it is enough that there is a right to call some unidentified part of the issue—the history and underlying purposes of the provision require, we submit, that it be construed narrowly.

1. Throughout the history of the statute, the basic principle underlying the Congressional action has been the recognition of the sound accounting practice of matching costs against revenues by permitting an offset against nominal interest receipts of a part of the premium paid for the right to receive the above-market interest. And each time the statute has been construed to permit deductions not justified by that principle, Congress has promptly responded with corrective legislation and a reaffirmance of the basic purpose.

Prior to 1942, as we have noted, no amortization of bond premiums was authorized. To alleviate the resulting distortion of income, the Treasury proposed the adoption, in the Revenue Act of 1942, of what

became Section 125 of the 1939 Code. The reasons for the Treasury-sponsored proposal, as explained by its spokesman, were that (1 House Hearings, Revenue Revision of 1942, p. 90):

> * * * the premium at which a bond is obtained represents to the holder merely an effective yield lower than the actual interest rate * * *. The difference between the yield and the actual interest rate is simply a return of capital and should be treated as such rather than as a capital loss. * * * Since the yield rather than the actual interest rate reflects the true income to the taxpayer, only that income should be subject to tax and the capital loss should disappear.

The House committee endorsed the recommendation, explaining (H. Rep. 2333, 77th Cong., 2d Sess., p. 47):

> Under existing law, bond premium is treated as a capital loss sustained by the owner of the bond at the time of disposition or maturity and periodical payments on the bond at the nominal or coupon rate are treated in full as interest. The want of statutory recognition of the sound accounting practice of amortizing premium leads to incorrect tax results * * *.[1]

Although noting that underlying purpose, this Court in *Commissioner* v. *Korell*, 339 U.S. 619, concluded

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[1] The committee also noted the need to require holders of tax-exempt bonds to amortize bond premium (as a reduction of basis) in order to prevent their being allowed a capital loss on disposition even though, to the extent of the premium, a part of the capital has been recovered "in the guise of interest" which was exempt from tax. H. Rep. 2333, 77th Cong., 2d Sess., p. 47.

that there was no basis in the statute for presuming amortization of the premiums paid for a bond, not because of the interest rate it bore, but because it was convertible into preferred stock selling at a price much greater than the face amount of the bond. Congress promptly responded to the disclosure of that unintended loophole by adding a provision that, in the case of a convertible bond, the deductible premium shall not "include any amount attributable to the conversion features of the bond" (Section 125(b)(1), as amended by the Revenue Act of 1950, Sec. 217(a), 64 Stat. 906). In doing so, it reaffirmed the basic purpose of the provision (H. Rep. 2319, 81st Cong., 2d Sess., p. 47):

> Section 125 was intended primarily to deal with the case where the premium was paid because the security bore a stated rate of interest higher than that prevailing in the current market for securities of a like risk and a similar life. Equity required the allowance of a deduction against ordinary income in cases of this sort.

In the light of that reaffirmed purpose, it is clear that the immediate write-off over a 30-day period of large premiums paid for 30-day callable bonds produces results that Congress could not have intended. Not only do the premiums paid for such bonds tend to reflect their tax advantages rather than their favorable interest rates, but the period over which the amortization is taken has no relationship to the receipt of the "interest" for which the premium is presumed to be paid. Yet, as we have noted in Point I, *supra*,

neither the Commissioner nor the courts have found any way to prevent that result under the language of the statute. Again, however, when that abuse of its original purpose was brought to its attention, Congress took corrective action.

In the committee reports that accompanied the successor provision of the 1954 Code (Section 171), Congress took note of and attempted to narrow the abuse arising from 30-day write-offs (H. Rep. 1337, 83d Cong., 2d Sess., p. 26):

> Under existing law, a bond premium may be amortized with reference to the amount payable on maturity or earlier call date, at the election of the taxpayer. In the case of bonds with a very short call feature, such as those providing for call at any time on 30-day notice, the entire premium may be deducted in the year of purchase.
>
> This provision has given rise to tax-avoidance opportunities. Substantial bond issues have been made subject to a 30-day call, permitting the purchaser to take an immediate deduction for the entire premium against ordinary income. Where the call feature is nominal or inoperative this permits a deduction for an unreal loss, since the market value of the bonds ordinarily remains fairly stable over considerable periods. The bonds may then be resold after 6 months subject to long-term capital gain treatment. The writeoff of premium thus affords a gratuitous tax saving, equivalent to the conversion of a corresponding amount of ordinary income into capital gain. This process may be repeated indefinitely.

> To curb this type of abuse, your committee's bill provides that the premium on callable bonds may be amortized to the nearest call date only if such date is more than 3 years from the date of original issue of the securities. This provision will apply only to bonds issued after January 22, 1951, and acquired after January 22, 1954.

The limitation adopted in the 1954 Code proved, however, to be ineffective to curb the abuse, since it excepted many outstanding issues as well as any bonds in which the right of call did not first arise until three years after the original *issue* (*i.e.*, even though at the date of *purchase* the bonds were subject to call upon notice). Congress finally closed the loophole—for reasons substantially the same as those recited in the 1954 committee reports[3]—by the Technical Amendments Act of 1958, Section 13, 72 Stat. 1620. The remedy there adopted was, in substance, to eliminate, as to any bonds purchased after January 1, 1958, the right to amortize to call dates and to require amortization to be taken only over the period to maturity.[4]

What that history shows is an original purpose of Congress to permit, in accordance with "sound accounting practice," a deduction from nominal interest receipts of the amount constituting a return of capital rather than a true interest "yield," together with a

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[3] See H. Rep. No. 775, 83d Cong., 1st Sess., p. 11.

[4] The amended Section 171 literally permits amortization to an earlier call date but only if it results in a *smaller* amortization deduction than would amortization to maturity, which, for all practical purposes, effectively eliminates the privilege.

persistent effort by Congress to narrow the provision whenever it was construed to permit deductions not justified by that purpose. While the history does not in terms bear on the precise issue here—whether a right to redeem 1% of an issue establishes an "earlier call date" for the entire issue—it does require, we submit, an interpretation of the statute, if available, that at least does not extend the scope of the revealed abuses. As the subsequent legislative action shows, allowing a 30-day amortization of bond premium is far removed from the original purpose even when the entire issue is subject to call on 30 days' notice. But it is a still much larger step, and more egregious flouting of Congressional purpose, to interpret the statute as permitting the same result where the right of call is limited to a small fraction of the issue. In such a case, even if the right were exercised, there would be but a nominal statistical chance that any particular bond would be redeemed, and thus there is not even the theoretical justification that each bond is held at the sufferance of the issuer.

While we believe that the statute requires the interpretation of "earlier call date" we have contended for, it must, at the very least, be acknowledged to permit it. And if it is a permissible interpretation, the history of the statute requires, we submit, that it be adopted.

2. Petitioners' claim that the legislative history supports their contention is without substance. We have acknowledged that that history does support an interpretation of Section 125 as permitting a 30-day write-off of the premium on bonds *generally* callable

on 30 days' notice (Point I, *supra*), and that by itself provides a sufficient explanation why Congress undertook to narrow the provision in 1954 and 1958. But there is nothing to show that Congress ever endorsed the immediate amortization of the premium on an entire issue of bonds on the basis of an issuer's right to redeem a small fraction of the issue. In short, while the history supports an interpretation that a right to call all of the bonds on notice establishes an "earlier call date" for all the bonds, it does not support an interpretation that a right to call 1% of the bonds, drawn by lot, establishes an "earlier call date" either for the entire issue or for any particular bond in the issue.

Petitioners point out that, in the hearings on the 1942 Act, one of the witnesses who opposed the provision noted the ambiguity of the proposed language and the problems it would raise in application, giving as an example the question involved here—namely, whether the "earlier call date" provision applied only to general rights of call or also to special rights of call (Br. 24-25). That event proves, we acknowledge, that the witness was far-sighted. The language of the statute is, as he claimed, not clear on the question and it has produced difficulties of administration. But that Congress adopted the provision despite the objection hardly helps to show which resolution of the ambiguity Congress intended—if, indeed, it paid any heed to the question.

Petitioners' second offer of evidence that Congress endorsed amortization on the basis of special, as distinguished from general, redemption provisions is even

more farfetched. The staff of the Joint Committee on Internal Revenue Taxation prepared a summary of the bill that became the 1954 Code. In the discussion of the narrowed bond-amortization provision (noted at pp. 33-34, *supra*), the staff gave an example of the abuses permitted by the prior law which, for emphasis, it noted was based on "recent figures of an actual bond issue." The example given was of a bond selling at 120 and "callable on 30 days notice at 102," the staff noting that prior law permitted an immediate deduction of the 18-point spread between the purchase price and the "call price." See Br. 23. Consulting the terms of the more popular issues of 30-day callable bonds then being utilized for tax-saving purposes, petitioners conclude that the *figures* used by the staff must have been taken from an issue of Appalachian Electric Power Company bonds and point out that the only redemption price in that issue approximating 102 was in fact the special call price. Assuming the product of petitioners' thorough research to be true, it is sufficient to note the unlikelihood that any member of Congress engaged in the same research or knew that the stated price was based on the special, rather than the general, redemption provisions of the unidentified bond issue.

The straws at which petitioners grasp are by themselves persuasive proof that nothing in the legislative history shows a Congressional endorsement of amortization on the basis of special redemption provisions. It shows only that Congress was aware generally of the abuses produced by amortization of 30-day callable bonds, and assumed them to be permitted by the prior

law. But those abuses existed to a more than ample extent in amortization based on general rights to call on 30 days' notice, and there is no indication that Congress thought the loophole had been, or could be, extended still further to include special and limited rights of call.

C. THE UNPUBLISHED PRIVATE RULING LETTERS UPON WHICH PETITIONERS RELY, ADDRESSED TO THIRD PARTIES AND SINCE REVOKED, HAVE NO BINDING EFFECT

In several unpublished private ruling letters, addressed to individual taxpayers in response to requests for advice, the Commissioner advised the recipients that they were entitled to amortization deductions based on the "special" redemption price provided for in stated bond issues. Three such requests and ruling letters, produced by the government in response to interrogatories in another case, appear in the record (R. 50–66). Those rulings were granted in 1962 and 1963. In March 1966, the individual ruling letters were revoked and the Commissioner issued, and published, a formal Revenue Ruling holding that amortization was allowable only on the basis of a "general" call price. Rev. Rul. 66–308, 1966–2 Cum. Bull. 284. Petitioners contend that the issuance of the private rulings to third parties estopped the Commissioner to deny "special" call price amortization for any years prior to 1966, the date of the revocation of those rulings and the publication of a contrary ruling.

1. It is settled that private rulings, addressed to individual taxpayers, have no binding effect as to other taxpayers. E.g., *Automobile Club* v. *Commis-*

sioner, 353 U.S. 180; *Commissioner* v. *P. G. Lake, Inc.*, 356 U.S. 260, 265-266, n. 5; *Helvering* v. *New York Trust Co.*, 292 U.S. 455, 467-468; cf. *Knetsch* v. *United States*, 364 U.S. 361, 370." Indeed, petitioners' claim that a published ruling departing from prior ruling letters cannot be applied "retroactively" is answered by the Code itself, which expressly gives the Commissioner discretion to determine to what extent rulings shall be applied without retroactive effect (Section 3791(b) of the 1939 Code; Section 7805(b) of the 1954 Code). Pursuant to that authority, the Treasury Regulations provide that rulings issued to individual taxpayers will not generally be revoked retroactively as to the particular recipients but that other taxpayers are not entitled to rely upon them unless they are published in the Internal Revenue Bulletin. Treas. Regs. on Procedural Rules (1954 Code), Section 601.201(l) (4), (5), and (7). Unpublished rulings or administrative practice are similarly not presumed to have been known to Congress and therefore gain no added status by virtue of reenactment of the statute. *Commissioner* v. *P. G. Lake, Inc.*, *supra*.

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[9] In the *Knetsch* case, the Court refused to consider an argument made by an *amicus curiae* that Knetsch had in fact *relied* on individual ruling letters issued to other taxpayers, since Knetsch himself had not advanced that argument. Apart from the question of the effect of actual reliance, however—which has similarly not been claimed here—the *Knetsch* case necessarily holds that the private ruling letters issued to other taxpayers did not operate as interpretations of the law binding upon the Commissioner. See also *Goodstein* v. *Commissioner*, 267 F. 2d 127, 132 (C.A. 1); *Weller* v. *Commissioner*, 270 F. 2d 294, 298-299 (C.A. 3), certiorari denied, 364 U.S. 908.

2. Apparently aware that individual ruling letters as such have no binding force, petitioners attempt to lift the private rulings to the status of "regulations" by characterizing them as interpretations of the regulations and thus a gloss upon the regulations having the same effect as though a part of them. The premise of the contention is specious. Private rulings gain no greater status by being based on an interpretation of regulations than they would have if based on an interpretation of the statute. In any event, the rulings in question were in no meaningful sense interpretations of the regulations—as distinguished from the statute—since there is nothing in the regulations bearing on the question other than their repetition of the statutory language.

The crucial language of the statute is that allowing amortization to an "earlier call date." The regulations, echoing the statute and repeating almost verbatim the committee reports (see Pet. Br. 30), simply provide that "in the case of a callable bond" the bond premium may be amortized "down to the earlier call date," adding that (Treas. Regs. 118, Section 39.125 (b)–2(a)):

> * * * The earlier call date may be the earliest call date specified in the bond as a date certain, the earliest interest payment date if the bond is callable at such date, the earliest date at which the bond is callable at par, or such other call date, prior to maturity, specified in the bond as may be selected by the taxpayer. * * *

That provision, it may be seen, simply provides for the taxpayer's election among the several "call dates" if there is more than one date on which "the bond is

callable". What kinds of redemption rights suffice to establish a "call date" for a particular bond is a question no more specifically dealt with in the regulation than in the statute. Thus the private rulings, treating a limited right to call bonds out of a sinking fund as establishing an "earlier call date" for the entire issue, were in no way based upon an "interpretation" of anything in the regulations as distinguished from the statute. They were simply a tentative administrative resolution, later concluded to have been erroneous, of a question raised by the statute and left untouched by the regulations.

There is equally no substance to petitioners' claim that, in this instance, the private rulings were an exercise of a "legislative" power delegated to the Commissioner. That argument is based on the provisions of the statute requiring the determination of the amount of the bond premium and of the portion of the premium attributable to the taxable year to be made in accordance with the method regularly employed by the taxpayer, if reasonable, or "in accordance with regulations prescribing reasonable methods of amortizing bond premium, prescribed by the Commissioner with the approval of the Secretary" (Section 125(b)(3)(B)). Assuming that delegation includes a "legislative" power to prescribe, among other things, what kinds of redemption rights are sufficient to establish an "earlier call date" (the question here), it is a power exercisable, by the express terms of the statute, only by regulations and not by individual ruling letters. And the regulations, as we have seen, say nothing about the matter and thus do not even

purport to be an exercise of such a power."[11] Indeed, for all their emphasis upon the "legislative" character of the regulations, petitioners fail ever to specify what it is in the regulations that they deem to be an exercise of a legislative power relevant to the issue in this case. The reason, we submit, is that they cannot.

However the matter is viewed, the unavoidable fact remains that it is only upon the unpublished ruling letters themselves—and nothing to be found in the regulations—that petitioners ultimately rely. Those rulings, as the Commissioner soon recognized upon fuller consideration, were erroneous and extended an unwarranted tax windfall to the recipients. Fortunately, however, the law is not and never has been that the Commissioner, having once mistakenly given a windfall to one taxpayer, is thereafter forever bound to give the same windfall to all others. He was not bound to do so here, and having perceived his original error, he quite properly took steps to remedy it.

III

A RIGHT TO REDEEM AN INDETERMINATE NUMBER OF UNIDENTIFIED BONDS IF AND WHEN STATED CONTINGENCIES SHOULD OCCUR DOES NOT ESTABLISH AN "EARLIER CALL DATE" FOR ANY BONDS IN THE ISSUE

We have considered above two of the three different kinds of redemption rights created by the bond inden-

[11] If anything, we suggest, the reference in the regulations to a "call date" as being a date upon which "*the bond* is callable" serves to emphasize the statutory requirement that, to be subject to "call date" amortization, the particular bond—and not merely an unidentified part of an issue to be drawn by lot—must itself be subject to redemption on an ascertainable date.

tures in this case: (1) a general and unconditional right to redeem all or any part of the bonds on 30 days' notice, which we concede provides a basis for rapid amortization; and (2) an unconditional right to redeem an unidentified 1% of the bonds at any time upon 30 days' notice, which we contend does not provide a basis for amortization. There remains for brief consideration a third kind of redemption right retained by the issuers: (3) a *contingent* right, if and when certain stated events occur, to redeem an indeterminate number of bonds.

The indentures in this case gave the issuers the right to redeem bonds at the "special" price not only out of the "sinking fund" but also out of any amounts deposited to several other funds, which can collectively be referred to as the "property funds." Those funds, variously described, consisted of amounts the issuer was required to deposit, for the protection of the bondholders, if certain events impairing the value of the security occurred. Although there are minor differences between the two indentures involved, the conditions under which deposits were required under either indenture all fall within one or more of the following: (1) the taking of property by eminent domain; (2) the destruction of property by casualty; (3) the issuer's sale of property released from the mortgage for that purpose; or (4) the issuer's failure to expend stated amounts for maintenance or improvement of the property. The issuers retained various options to make capital additions in lieu of any required deposits, but they had no right to make additions to the funds (*i.e.*, to enable them to exercise

the special redemption rights) beyond those required by the occurrence of the stated contingencies.

The redemption rights resulting from those provisions are basically different in nature from those arising from the "sinking fund" provisions. Each issuer had an unconditional right to deposit stated amounts to the sinking fund and thus had an *unconditional* right to redeem bonds up to that amount (1% of the issue for the year involved). Deposits to the "property funds," however, could be made only if stated events occurred, and thus the right to redeem from those funds was a *contingent* as well as a limited one.[12] Some of the contingencies were entirely beyond the control of the issuer (*e.g.*, eminent domain or casualty losses). Others were legally within the control of the issuer (*e.g.*, the right not to maintain the property), at least with the approval of the trustee (sale of properties), but could be brought about by the issuer only by suffering onerous consequences—and even then hardly within the 30-day period for which amortization is claimed.

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[12] At the time of the Gouriellis' bond purchases, there was already on deposit in Appalachian's released property fund the amount of $42,636 arising from a prior release of property. Although the money was later withdrawn by Appalachian for property additions, it was legally available, at the date of purchase, for redemption of $42,000 face amount of bonds out of the 1981 series totalling $17,000,000. To that extent, therefore, the redemption right was unconditional and stood on the same footing as Appalachian's unconditional right to deposit 1% of the bond issue into the sinking fund and then utilize that amount to redeem bonds at the special price, the question considered in Point II. We consider here only the additional rights of redemption that might arise in the event of future additions to the property funds.

Since the redemption rights arising from the "property fund" provisions were, like the "sinking fund" rights, limited in amount (the amount being determinable by the event precipitating the right), all of the reasons why the "sinking fund" rights did not establish an "earlier call date" (discussed in Point II) are equally applicable to the "property fund" rights. In addition, however, the "property fund" redemption rights, unlike the "sinking fund" rights, were not yet even in being in the year of purchase and would come into being only if stated events happened to occur—necessarily at some indeterminate time in the future. Thus no date of any sort upon which those rights would become exercisable can be identified. For that additional reason, therefore, there can be no claim that those provisions establish an "earlier call date" on the basis of which amortization might be taken. In short, if the unconditional but limited "sinking fund" redemption rights do not provide a basis for amortization—as we have shown in Point II—then *a fortiori* the "property fund" redemption rights do not, since they are both contingent *and* limited.

CONCLUSION

Although the ultimate issue in this case is the amount of the amortization allowable (whether the excess over the "special" price or only the excess over the "general" price), that question turns, not, as petitioners would have it, upon the interpretation of the statutory phrase "amount payable" but upon the interpretation of "earlier call date." The question is which of the several different kinds of redemption

rights involved establishes an "earlier call date" for the bonds and thereby provides a basis for amortization. Once it is determined which of the redemption provisions creates the right to amortize a premium, the relevant "amount payable" (with reference to which the amount of "bond premium" is to be determined) follows automatically—namely, the price that must be paid upon an exercise of the redemption rights under that provision. For the reasons we have shown, the only redemption right under the bond indentures involved here that establishes an "earlier call date" for the petitioners' bonds is the general right to redeem all or any part of the bonds at any time upon 30 days' notice. It follows that the amortizable bond premium must be measured by the excess of the purchase price over the price at which that redemption right could be exercised—*i.e.*, the so-called "general" price. The judgment below, allowing that measure of amortization, should therefore be affirmed.

Respectfully submitted.

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FEBRUARY 1962.

APPENDIX

Internal Revenue Code of 1939 (26 U.S.C., 1952 ed.):

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(v) [as added by Sec. 126(a), Revenue Act of 1942, c. 619, 56 Stat. 798] *Bond Premium Deduction.*—In the case of a bondholder, the deduction for amortizable bond premium provided in section 125.

* * * * *

SEC. 125 [as added by Sec. 126(b), Revenue Act of 1942, *supra*]. AMORTIZABLE BOND PREMIUM.

(a) *General Rule.*—In the case of any bond, as defined in subsection (d), the following rules shall apply to the amortizable bond premium (determined under subsection (b)) on the bond for any taxable year beginning after December 31, 1941:

(1) *Interest wholly or partially taxable.*—In the case of a bond (other than a bond the interest on which is excludible from gross income), the amount of the amortizable bond premium for the taxable year shall be allowed as a deduction.

* * * * *

(b) *Amortizable Bond Premium.*—

(1) [as amended by Sec. 217(a), Revenue Act of 1950, c. 994, 64 Stat. 906] *Amount of bond premium.*—For the purposes of paragraph (2), the amount of

bond premium, in the case of the holder of any bond, shall be determined with reference to the amount of the basis (for determining loss on sale or exchange) of such bond, and with reference to the amount payable on maturity or on earlier call date, with adjustments proper to reflect unamortized bond premium with respect to the bond, for the period prior to the date as of which subsection (a) becomes applicable with respect to the taxpayer with respect to such bond. In no case shall the amount of bond premium on a convertible bond include any amount attributable to the conversion features of the bond.

(2) *Amount amortizable.*—The amortizable bond premium of the taxable year shall be the amount of the bond premium attributable to such year.

(3) *Method of determination.*—The determinations required under paragraphs (1) and (2) shall be made—

(A) in accordance with the method of amortizing bond premium regularly employed by the holder of the bond, if such method is reasonable;

(B) in all other cases, in accordance with regulations prescribing reasonable methods of amortizing bond premium, prescribed by the Commissioner with the approval of the Secretary.

* * * * *

Treasury Regulations 118 (1939 Code):

Sec. 39.125(b)-1 *Bond premium and amortizable bond premium.* (a) Bond premium on any bond to which section 125 applies is the excess of the amount of the basis (for determining loss on sale or exchange) of the bond over the amount payable at maturity or, in the

case of a callable bond, earlier call date. For determination of applicable call date see Sec. 39.125(b)–2. * * *

* * * * *

(c) Amortizable bond premium on any bond to which Section 125 applies is such part of the bond premium on the bond as is attributable to the taxable year.

Sec. 39.125(b)–2 *Callable and convertible bonds.* (a) The fact that a bond is callable or convertible into stock does not, in itself, prevent the application of section 125. For the purposes of such section, in the case of a callable bond the earlier call date will be considered as the maturity date and the amount due on such date will be considered as the amount payable on maturity, unless the taxpayer regularly employs a different method of amortization which is reasonable. Hence, the bond premium on such a bond is required to be spread over the period from the date as of which the basis for loss of the bond is established down to the earlier call date, rather than the maturity date. The earlier call date may be the earliest call date specified in the bond as a day certain, the earliest interest payment date if the bond is callable at such date, the earliest date at which the bond is callable at par, or such other call date, prior to maturity, specified in the bond as may be selected by the taxpayer. A taxpayer who deducts amortizable bond premium with reference to a particular call date may not thereafter use a different call date in the calculation of amortization deductions with respect to such premium.

* * * * *

Sec. 39.125(b)–5 *Methods of amortization.* (a) The determinations of the bond premium and amortizable bond premium on any bond to which section 125 applies shall be made in accordance with:

(1) The method of amortization regularly employed by the taxpayer, if such method is reasonable; or

(2) The method of amortization prescribed by this section.

A method of amortization will be deemed "regularly employed" by a taxpayer if the method was consistently followed in taxable years beginning before January 1, 1952, or if for taxable years beginning on or after such date a taxpayer who has never previously taken a deduction for amortization initiates in the first taxable year for which such a deduction is taken a reasonable method of amortization and consistently follows such method thereafter. * * * It is sufficient if the taxpayer regularly employs a method of amortization and if such method is reasonable.

(b) The method of amortization prescribed by this section is as follows:

(1) The bond premium on any bond to which section 125 applies shall be determined in accordance with Sec. 39.125(b)-1 and shall be computed as of the end of the taxable year (or as of the date of disposition or redemption of the bond, if it was disposed of or redeemed in the taxable year) but without regard to the amortizable bond premium for the taxable year; and

(2) The amortizable bond premium on such bond for the taxable year shall be an amount which bears the same ratio to the bond premium on the bond as the number of months in the taxable year during which the bond was owned by the taxpayer bears to the number of months from the beginning of the taxable year (or, if

the bond was acquired in the taxable year, from the date of acquisition) to the date of maturity or earlier call date. For the purposes of this subparagraph, a fractional part of a month shall be disregarded unless it amounts to more than half a month, in which case it shall be considered as a month.

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